



**CalPERS**  
**Investment Office**

P.O. Box 2749

Sacramento, CA 95812-2749

Telecommunications Device for the Deaf - (916) 795-3240

Telephone: (916) 795-3400

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**AGENDA ITEM 8b**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Executive Compensation Strategic Plan Update
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

**Executive Summary**

Over the last three years, staff has implemented the Investment Committee's three-year Executive Compensation Strategic Plan (Plan) This agenda item marks the conclusion of CalPERS' dedicated Plan. The initiation of a time-certain extension to CalPERS' Plan is not recommended. Rather, Staff believes it more effective to imbed two basic objectives into CalPERS' existing Corporate Governance Program framework in order to improve: 1) disclosure and transparency; and, 2) an alignment of interest between executive compensation practices and the creation of shareowner value.

Going forward, the Corporate Governance Focus List, Proxy Voting, Education & Influence, and Investment Programs will be utilized to improve disclosure and the alignment of interest between corporate management, directors and shareowners through executive compensation practices. To summarize:

- Focus List Program: Staff will engage and promote targeted company specific reform at Focus List companies where there is a lack of disclosure or egregious executive compensation practices exist. CalPERS' Focus List screening methodology will include dedicated metrics related to executive compensation practices. And, Staff will identify opportunities to specifically

engage compensation committee members at Focus List companies in order to raise the committee's level of accountability to shareowners.

- **Proxy Voting Program:** Staff will use the new SEC mandated executive compensation proxy disclosure requirements to apply CalPERS' proxy voting responsibilities where consistent with CalPERS' Principles of Accountable Corporate Governance. In addition, Staff will identify opportunities to amend CalPERS' Principles to stay current with evolving trends in executive compensation practices.
- **Education & Influence Program:** Staff will seek opportunities to engage stock exchanges, equity market regulators, governmental authorities, and institutional investors to promote reform that improves executive compensation disclosure and pay-for-performance practices. And, staff will continue to develop its existing relationships with relevant entities such as the compensation consulting industry, while continuing to offer CalPERS as a resource to congressional members such as U.S. Representatives Barney Frank and Henry Waxman.
- **Corporate Governance Investment Program:** Where appropriate, staff will seek opportunities to achieve excess investment returns through executive compensation practices at companies associated with the Co-Investment Strategy.

### **Background**

Compensation programs are one of the most powerful tools available to align the interests of executive managers with those of shareowners. On November 15, 2004, the Committee approved a three-year Plan to raise the level of accountability to shareowners at public company boards and compensation committees. Over the last three years, staff has provided periodic updates to the Committee on efforts to implement executive compensation reform as it pertains to the following macro and micro economic strategies:

#### **Macro Economic Strategies:**

1. SEC engagement
2. SRO/Exchange engagement
3. Compensation consulting industry engagement

#### **Micro Economic Strategies:**

1. Promoting reform at the largest companies
2. Enhancing compensation committee accountability
3. Recognizing pay-for-performance leaders

Staff's reporting structure to the Committee over the last three years has been two tiered: an open session item communicating updates on the Committee's macro economic strategies, and a closed session item communicating updates on targeted micro economic company-specific initiatives.

### **Summary of CalPERS Actions**

Over the last three years, staff has met with the New York Stock Exchange, the Security and Exchange Commission, numerous investor groups, the largest executive compensation consulting firms and members of the U.S. Congress in order to effect positive change in pay-for-performance standards, as well as disclosure and transparency for shareowners. Table 1 summarizes a series of actions that resulted from implementing the Committee's three-year Plan.

**Table 1**  
**Summary of CalPERS Actions**

<b>SEC Engagement:</b> SEC engagement by way of face-to-face meetings and formal comment letters advocating enhanced disclosures, transparency, pay-for-performance practices and director accountability to shareowners.
<b>SEC Engagement:</b> SEC engagement as part of a collaborative effort involving both large institutional investors and leading institutions in the compensation consulting industry.
<b>NYSE Engagement:</b> NYSE engagement to encourage Exchange involvement in improving transparency in executive compensation of listed companies.
<b>U.S. Congress Engagement (Rep. Henry Waxman):</b> Staff has engaged U.S. Representative Henry Waxman's office to offer CalPERS as a resource in understanding the role of the compensation consulting industry in formulating and advising companies on executive compensation.
<b>U.S. Congress Engagement (Rep. Barney Frank):</b> At the CalPERS 2006 Federal Workshop in Washington, DC, members of the Investment Committee and staff met with Congressman Barney Frank (D-MA) to discuss House Resolution 4291 (Barney Frank, (D-MA)) "The Protection Against Executive Compensation Abuse Act" and to express CalPERS' support position for the bill.
<b>Compensation Consulting Industry Engagement:</b> Staff development of an ongoing constructive working relationship with the executive compensation consulting industry resulting in collaboration on compensation issues of mutual concern.
<b>Compensation Consulting Industry Engagement:</b> Recommendation to the compensation consulting industry that they improve the disclosure of their conflicts of interest with corporate clients.

<p><b>U.S. House Legislation Support (Rep. Barney Frank):</b> Staff reviewed Representative Barney Frank's "Protection against Executive Compensation Abuse Act." Both Global Equity and Government Affairs staff worked together in analyzing House Resolution (HR) 4291 (Barney Frank, (D-MA)) "The Protection Against Executive Compensation Abuse Act" to determine the consistency of the bill with CalPERS' principles for executive compensation. In keeping with the conclusion reached by Global Equity and Government Affairs staff, the Board of Administration accepted a support recommendation presented by the Government Affairs Office. Christy Wood, Senior Investment Officer Global Equity, represented CalPERS' support position for House Resolution (HR) 4291 by testifying before the U.S. House Financial Services Committee.</p>
<p><b>Options Backdating Initiative:</b> Implementation of initiative targeting global equity portfolio holdings that are being investigated by the SEC for alleged employee stock option backdating. The initiative included written engagement of companies identified by the SEC as being under investigation for options backdating, as well as a withhold vote initiative from directors linked to a company where the chief executive relinquished the CEO position and where it could be determined that the director in question oversaw the company's compensation practices during the time of options backdating occurrence.</p>
<p><b>Clawback Policy Initiative:</b> Implementation of an initiative to get the largest U.S. companies to adopt and disclose a clawback provision for their compensation plans.</p>
<p><b>New CalPERS Principles:</b> CalPERS adopted new executive compensation principles recommending that companies adopt and disclose provisions for recapturing bonus and incentive payments ("Clawback Policy"), and a methodology for approving stock options for both directors and employees of the company, as a result of the options backdating scandals.</p>
<p><b>Advisory Vote on Executive Compensation Support:</b> CalPERS has become a member of a working group consisting of both global institutional investors and large US corporations to evaluate the implications of the adoption of an advisory vote on executive compensation by US issuers.</p>
<p><b>Advisory Vote on Executive Compensation Support:</b> CalPERS has publicly encouraged companies to adopt a shareowner advisory vote on executive compensation and supported shareowner proposals requesting corporate adoption of such a policy.</p>
<p><b>External Forum Presentations:</b> CalPERS Staff has made comprehensive presentations at meetings of the California Business Roundtable and the Aspen Institute related to CalPERS' position on executive compensation.</p>

## **Summary of CalPERS Accomplishments**

### **Lasting Market & Company Specific Reforms**

CalPERS has been directly involved in initiatives that have produced several reforms that should have positive long-term implications for executive compensation practices. One reform is the executive compensation disclosure rule approved by the Securities and Exchange Commission (SEC). This ruling is the first amendment to SEC executive compensation disclosure rules in more than a decade. The new SEC rule provides greater transparency to investors about executive compensation than ever before. While the rule does not contain

every recommendation proposed to the SEC by CalPERS, it is more “investor friendly” than the previous SEC rule on executive compensation disclosure.

Through the engagement of portfolio companies and the successful filing of shareowner proposals at portfolio companies, CalPERS has been successful in getting portfolio companies to implement executive compensation policies that better align the long-term interest of shareowners and management. Examples are shown in Table 2.

**Table 2**  
**Examples of Executive Compensation Reforms**

<b>Aon Corp.:</b> Agreed to improve the disclosure of payout methodology for long-term equity awards.
<b>AT&amp;T:</b> Implemented a new change in control severance plan for officers that replaced all previous plans. Under the new plan, following a change in control and termination, officers will only receive 2.99X base + bonus, no tax ups, and no cash payouts for performance shares.
<b>Cardinal Health:</b> Implemented a policy (and amended existing employment contracts) to require shareowner approval for any severance payout that exceeds 2.99X base + bonus (only) – excludes equity.
<b>Clear Channel:</b> Amended bylaws to include exact language from CalPERS' 2.99X shareowner approval severance proposal.
<b>Home Depot:</b> Implemented a clawback policy for incentive payouts.
<b>Shaw Group:</b> Agreed to reduce CEO contract from a possible payout of 10X base + bonus in the event of a change in control, to 3X base + bonus.
<b>Tupperware:</b> Agreed to formally disclose its clawback policy on its website and in its 2007 Proxy; previously developed by the Company but not disclosed.

## **Disclosure & Transparency**

CalPERS has addressed the issue of improvement in executive compensation disclosure and transparency through four initiatives. First, CalPERS, along with other large institutional investors and the executive compensation consulting industry, met with SEC staff to provide the group's recommendations for the new SEC rule on executive compensation disclosure. Second, staff is engaging portfolio companies that are responding to an SEC inquiry into the company's option grant practices. Staff's engagement with these companies emphasizes the importance of complete transparency and public disclosure by the results of the review into the company's option grant practices by an independent committee of the Board of Directors.

Third, staff is requesting that portfolio companies being engaged on executive compensation matters, through either the Focus List or Strategic Plan, improve the disclosure and transparency of performance metrics used for awarding incentive compensation. Fourth, CalPERS is working to improve disclosure and transparency of executive compensation by its encouragement of and support for the corporate adoption of an advisory vote on executive compensation. For the 2008 proxy voting season, CalPERS will continue to support shareowner proposals seeking the adoption of an advisory vote policy for executive compensation. In addition, CalPERS will be identifying suitable target companies to submit and proactively solicit support for advisory vote shareowner proposals.

### **Engagement of Compensation Consultant Industry**

Staff acknowledges the potential conflicts that can occur between the executive compensation consulting industry, corporate issuers, and the corporate issuers' Board of Directors. Disclosure and transparency by all parties involved is an important tool for managing such conflicts. Staff has made the recommendation to the compensation consulting industry that they improve the disclosure of their conflicts of interest. In addition, staff is able to obtain, directly from the issuer, information that identifies the Board's compensation consultant and the relationship that consultant has with management. Staff also recommends to the issuer that they disclose information to the public about the relationship between the executive compensation consultant, management, and the Board of Directors.

CalPERS' staff has developed a constructive working relationship with the executive compensation consulting industry. For example, a working group comprised of CalPERS, the leading executive compensation consulting firms, and other large global institutional investors, was organized to develop recommendations for the Securities and Exchange Commission to improve disclosure and transparency for executive compensation. In addition, staff received valuable input from the executive compensation consulting industry during the development of CalPERS' option backdating policy and portfolio company engagement initiative. The executive compensation consulting industry also provided extensive corporate issuer data on executive compensation and pay for performance. Finally, staff is in the preliminary stages of organizing another collaborative effort with other global institutional investors and members of the leading executive compensation consulting firms to draft a "white paper" that would serve as guiding principles for corporate directors regarding pay for performance practices. The "white paper" could then be distributed to the Chair of the Compensation Committee for the 100 largest US companies in an attempt to change behavior and improve the alignment of interest between shareowners and executive compensation practices.

## Clawback Initiative

As a part of the Committee's Plan, there have been several achievements with respect to portfolio company development and adoption of formal clawback policies. In the second year of the three-year Plan, the Committee approved a dedicated Principle of Accountable Corporate Governance as follows:

- *Companies should develop and disclose a policy for recapturing incentive payments that were made to executives on the basis of having met or exceeded performance targets during a period of fraudulent activity or a material negative restatement of financial results for which executives are found personally responsible.*

CalPERS believes clawback policies are necessary to investors as they offer a mechanism to help recoup executive compensation during periods of fraudulent activity and ensure that management can be held accountable for their actions. Following adoption of the Committee's clawback policy principle, staff implemented a targeted company specific initiative aimed at advocating the adoption and disclosure of this executive compensation provision at portfolio companies. Staff initially identified 47 of the largest companies in CalPERS' portfolio that had not disclosed any form of a clawback policy. These companies fell into one of three buckets: 1) already had adopted a clawback policy but not disclosed; or, 2) were in the process of adopting a clawback policy; or, 3) had not adopted a clawback policy.

As of the writing of this agenda item, all 47 companies had either adopted and agreed to disclose a clawback policy; or, were in the process of reviewing such action at the board level. Of these companies, 34 have adopted a formal clawback policy as a result of CalPERS' engagement.

Two examples of acceptable clawback policies are as follows:

- **News Corporation, adopted August 2007 (Source: 2007 Proxy):  
Recoupment of Previously Paid Named Executive Officer Performance-Based Bonuses** – The company will require reimbursement, to the extent permitted by governing law and any employment arrangements, of the excess of any performance-based bonus paid to an executive officer where:
  - i. The payment was predicated upon the achievement of certain financial results that were subsequently the subject of a restatement.
  - ii. In the Board's view, the officer engaged in fraud or misconduct that caused the need for the restatement.
  - iii. And, a lower payment would have been made to the officer based upon the restated financial results.

In each such instance, the company will, to the extent practicable, seek to recover the amount by which the named executive officer's performance-based bonus for the relevant period exceeded the lower payment that would have been made based on the restated financial results, plus a reasonable rate of interest.

- **Alltel Corporation, (Source: 2007 Proxy): Policy for Recovery of Incentive Compensation in Event of Certain Financial Restatement –** Alltel's Board of Directors maintains a policy providing that in the event of a material restatement of Alltel's financial statements, the Board of Directors or the Compensation Committee shall take certain actions to recover incentive compensation paid or awarded to an executive officer of Alltel if (i) the executive officer has engaged in fraud or intentional misconduct that was a material cause of the restatement and (ii) there would have been a lower payment of incentive compensation to the executive officer had it been calculated based on the restated financial results.

### **Options Backdating Initiative**

As a part of the Committee's Plan, several actions were taken with respect to the options backdating scandals that took place over the last two years. In the second year of the three-year Plan, the Committee approved a dedicated Principle of Accountable Corporate Governance stated as follows:

- *The board's methodology and corresponding details for approving stock options for both directors and employees of the company should be highly transparent and include disclosure of: 1) quantity, 2) grant date, 3) strike price, and 4) the underlying stock's market price as of grant date. The approval and granting of stock options for both directors and employees should preferably occur on a date when all corporate actions are taken by the board. The board should also require a report from the Chief Executive Officer stating specifically how the board's delegated authority to issue stock options to employees was used during the prior year.*

Over the last two years, staff updated the Committee through both open and closed agenda items with regard to the engagement of companies that have received a notice of inquiry from the SEC pertaining to the backdating of stock options. CalPERS sent letters to approximately 85 companies recommending a series of actions be taken to address inadequate disclosure of stock option plan details, insufficient oversight of stock option plans by the board, and poor internal controls and audit practices, to ensure the integrity of financial reporting related to stock options.



In addition, CalPERS implemented a director withhold vote initiative targeted at directors identified to be directly associated with the stock options backdating issue. At companies where there has been a recent CEO departure due to options backdating, CalPERS withheld its vote from current directors that presided over the company's compensation committee during the historical period when stock options were backdated. As a result of this director withhold vote initiative, CalPERS voted against directors at KB Homes, McAfee, Monster Worldwide, and Affiliated Computer Services in 2007.

Due to the option backdating scandals, the U.S. Securities and Exchange Commission (SEC) and Internal Revenue Service (IRS) have taken action to address the issue. On June 15, 2007, the IRS issued an Industry Director Directive on backdated stock options, exemplifying the United States Department of the Treasury's increased focus on elevating the responsibility of the IRS for ensuring that the options backdating issue is identified, developed, and resolved, in a consistent manner for all companies. The SEC also adopted final rules on July 26, 2006, requiring all public companies to report the following information:

- The grant date and grant date fair value under FAS 123R
- The closing market price on the grant date, if it is greater than the exercise price of the option
- The date the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date.

Due to the elevated attention and action by the SEC and IRS, staff will cease its dedicated letter writing and director withhold vote initiatives tied to the options backdating issue with the conclusion of the Committee's three-year Plan. Staff believes that mandated company compliance and implementation of U.S. regulatory reporting requirements address the objective of CalPERS' dedicated initiatives tied to the options backdating issues.

### **Macro & Micro Strategies Not Achieved**

Over the last three years, CalPERS has been unable to achieve significant progress with regard to one macro and one micro economic strategy. First, the Committee approved a macro economic strategy directing staff to engage national stock exchanges in order to seek support in the development of executive compensation disclosure requirements. Staff met with the leadership at the NYSE to encourage the involvement of the Exchange in improving transparency in executive compensation of listed companies. While there was broad philosophical agreement that much improvement is needed, the Exchange was noncommittal in incorporating any formal policies into exchange listing standards.

Second, the Committee approved a micro economic strategy with the objective to recognize pay-for-performance corporate leaders by compiling examples of superior executive compensation practices and significant improvements in compensation plans. Staff has been unable to identify any one company that stands out as a stellar example of superior pay or transparency practices across all aspects that are relevant. While the original intent of the strategic plan was to publicly recognize pay-for-performance leaders, it has been difficult to fully vet all relevant issues.

**IV. STRATEGIC PLAN:**

This item is consistent with the Strategic Plan: Goal I, exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems.

**V. RESULTS/COSTS:**

Staff anticipates that existing resources are sufficient to support this effort.

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William Sherwood-McGrew  
Portfolio Manager  
Corporate Governance

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Dennis A. Johnson  
Senior Portfolio Manager  
Corporate Governance

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Christianna Wood  
Senior Investment Officer  
Global Equity

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Russell Read  
Chief Investment Officer